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MARGIN STOCKS[1]

THERE is a tendency even in the courts to treat the operations of stockbrokers as a mystery which outsiders cannot hope fully to comprehend. It is true that that part of the business which consists in buying and selling in the market and in borrowing and making deliveries and settlements is often highly technical and may require the exercise of considerable professional skill by the broker. Stock exchanges are established to facilitate and govern by appropriate rules transactions between brokers, who practice their profession in behalf of their customers or clients in much the same sense that an attorney practices in the courts.

"Doubtless, when one employs another to trade for him in a particular market, he impliedly authorizes the dealings to be conducted according to the established usages of that particular market, whether he knows of them or not. . . . Yet, he becomes bound only by such usages as are not illegal or contrary to sound public policy and 'are such as regulate the *mode* of performing the contracts, and do not change their intrinsic character.'"[2]

The general nature of margin transactions in stocks is now, however, well understood in the exchanges of this country both by customers and brokers. The main features consist in the employment

[1] "Margin stocks" are intended in this article to include all negotiable and fungible securities adapted to margin transactions.

[2] Rugg, C. J., in Hall *v.* Paine, 224 Mass. 62, 73, 112 N. E. 153 (1916). The italics are the writer's. See also Cronan *v.* Hornblower, 211 Mass. 538, 98 N. E. 504 (1912); Furber *v.* Dane, 203 Mass. 108, 116, 89 N. E. 227 (1909); Bibb *v.* Allen, 149 U. S. 481, 489 (1893); 21 AM. L. REG. (N. S.) 171, 176, note on Van Horn *v.* Gilbough, 10 W. N. C. 347 (Pa., 1881).

of a broker by the customer to purchase stock to be delivered to the customer on demand and payment of the broker's charges and advances toward the purchase price, or to be sold on his account if so ordered, with authority to the broker to pledge the stock in common with his own stock and that of other customers for his town loans. The contract of employment, if analyzed, conforms substantially with the contract as stated in *Markham* v. *Jaudon*,[3] and in *Richardson* v. *Shaw*.[4]

A word is necessary about "margins." A customer opening a margin account is generally required by the broker to deposit stock or to pay money to an amount equal to a certain percentage of the cost of the stock to be dealt in. The broker advances the remainder of the necessary money and charges interest upon it, for which, together with the broker's commission as agent, the customer is indebted. If stock is so deposited as "margin," it is, by the custom of brokers everywhere and generally by express agreement, merged with the stock of that kind purchased and carried for customers.[5] The "margin" at any particular moment is the difference between the current price of the shares purchased or deposited and the cash indebtedness of the customer, who agrees to keep this difference above a certain minimum percentage of the value of the stock. It

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[3] 41 N. Y. 235, 239 (1869).

[4] 209 U. S. 365, 374 (1908). The typical contract between broker and margin customer is thus described in this case and the case cited *supra*, n. 3: "The broker under takes and agrees — 1. At once to buy for the customer the stocks indicated. 2. To advance all the money required for the purchase beyond the ten per cent furnished by the customer. 3. To carry or hold such stocks for the benefit of the customer so long as the margin of ten per cent is kept good, or until notice is given by either party that the transaction must be closed. An appreciation in the value of the stocks is the gain of the customer, and not of the broker. 4. At all times to have, in his name and under his control, ready for delivery, the shares purchased, or an equal amount of other shares of the same stock. 5. To deliver such shares to the customer when required by him, upon the receipt of the advances and commissions accruing to the broker; or, 6. To sell such shares, upon the order of the customer, upon payment of the like sums to him, and account to the customer for the proceeds of such sale. Under this contract the customer undertakes — 1. To pay the margin of ten per cent on the current market value of the shares. 2. To keep good such margin according to the fluctuations of the market. 3. To take the shares so purchased on his order whenever required by the broker, and to pay the difference between the percentage advanced by him and the amount paid therefor by the broker."

[5] Furber *v.* Dane, 203 Mass. 108, 115, 89 N. E. 227 (1909); Crehan *v.* Megargel, 235 Mass. 279, 282, 126 N. E. 477 (1920).

seems, for reasons that later appear, that the present Massachusetts view is that the broker holds the legal title for the benefit of his customers, who are, therefore, the equitable owners. The doctrine in New York and other important jurisdictions is that the customers are legal owners as tenants in common of each kind of stock.[6] Corollaries of these doctrines respectively are that under the first the broker is secured for his advances and charges in the same way that a trustee is secured for his charges and expenses about the trust property, and that under the second the broker is in a position analogous to that of a pledgee of the undivided interest of the customer. He is, of course, not strictly a pledgee, as the undivided interest of a tenant in common is not capable of manual delivery.

The question of the property rights of customers has been more or less obscured by the existence of contractual relations with the broker. On the one hand a customer is indebted for the charges and advances of the broker, and on the other hand a broker has agreed to purchase and to carry or to sell stocks as ordered, and there are subsidiary obligations resting on both broker and customer; but none of these contractual relations necessarily affects the ownership of the stock acquired under the contract.

If a broker kept his transactions with each customer distinct from similar transactions with other customers, courts would never

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[6] 30 HARV. L. REV. 80, n.; Duel *v.* Hollins, 241 U. S. 523 (1916); Gorman *v.* Littlefield, 229 U. S. 19 (1913); Sexton *v.* Kessler, 225 U. S. 90 (1912); Richardson *v.* Shaw, 209 U. S. 365 (1908); Caswell *v.* Putnam, 120 N. Y. 153, 24 N. E. 287 (1890); Markham *v.* Jaudon, 41 N. Y. 235 (1869); Skiff *v.* Stoddard, 63 Conn. 198, 26 Atl. 874 (1893); Brewster *v.* Van Liew, 119 Ill. 554, 8 N. E. 842 (1886); Price *v.* Gover, 40 Md. 102 (1874); *In re* James Carothers & Co., 182 Fed. 501 (1910); s. c., 192 Fed. 693 (1910); *In re* A. O. Brown & Co., 171 Fed. 254 (1909); s. c., 183 Fed. 861 (1910); 8 COLUMBIA L. REV. 488, n.

Justice Holmes, who somewhat reluctantly concurred with his brethren in Richardson *v.* Shaw, *supra*, at p. 385, doubtless having in mind the opinion written by him in Chase *v.* Boston, 180 Mass. 458, 62 N. E. 397 (1902), while Chief Justice of the Massachusetts Supreme Judicial Court, describes a margin customer as "an *equitable* tenant in common." This description is wholly consistent with the actual decision in Chase *v.* Boston, where the broker was held to have the legal title, and accords with what seems to be the present Massachusetts view. Later in Sexton *v.* Kessler, *supra*, Justice Holmes, who wrote the opinion, seems to have overcome whatever lingering doubts he may have had. But an equitable tenancy in common, while consistent with the Massachusetts cases which deny the relation of pledgor and pledgee between customer and broker, is hardly compatible with the conception of the courts in other jurisdictions that the broker is a pledgee or in a position analogous to that of a pledgee.

have found serious difficulties in applying the ordinary principles of agency. The broker as agent would be under a contractual obligation to purchase or to sell the stock as ordered in behalf of his principal and the stock when purchased would be held by the broker as the property of his principal, either in law or in equity, depending on the manner in which the legal title was taken. Nor would the authority of the broker to pledge the stock for his own debts deprive a customer of his legal or equitable ownership. Of course the customer would take the risk that the broker might fail to redeem the pledge when called upon to make delivery; but in the mean time the general property rights in the stock itself would remain unchanged notwithstanding the pledge.

It is because brokers undertake margin transactions for many customers under substantially identical contracts with each that confusion has arisen as to the property rights of the customers, and in some jurisdictions, as in Massachusetts, it was once apparently denied that customers acquired any property rights at all. A broker never undertakes to distinguish between stocks of the same kind held for different customers, but this fact does not necessarily exclude them from all property interest even if the broker, as in Massachusetts, takes the legal title, for in that case there is no legal obstacle to his holding it for the benefit of all the customers who have purchased or deposited stock of that kind. On the other hand, if, as in other jurisdictions, the customers have the legal title, they are tenants in common of the stock.

So long as the broker is solvent and continues business, it matters little in practical results whether the broker or the customer owns the stocks purchased or deposited, because in the end the transaction is settled by the delivery of the stock to the customer on payment of his debt to the broker or, if he orders it sold, by an accounting between the two. It is, however, when the broker becomes bankrupt or meets with other financial disaster that the rights of ownership in the stock then in the broker's possession or control become paramount.

When a stockbroker goes into bankruptcy, two distinct fights are on: one between the margin customers and the general creditors, and the other among the margin customers themselves. The general creditors claim that the margin customers, like themselves, are merely creditors with no property rights, legal or equitable, in

the assets of the estate and that the indebtedness for which such customers may prove is the amount of their credit balances on the date of the bankruptcy. On the other hand, the margin customers say that they employed the broker as their common agent to buy and sell stocks and that in executing their commissions he acquired stocks which he holds in their behalf, so that these stocks cannot be reckoned among the general assets.

Again, when the margin customers turn from their common enemy, the general creditors, to the settlement of their internal differences, they seek all sorts of priorities and superior equities as against one another and to that end grasp at every device and circumstance to identify and to follow particular securities as belonging to themselves. In this attempt they are often successful before referees in bankruptcy, and occasionally in the district courts, because of the temptation to adopt principles of equity in following rights in property applicable to individuals who have no common interest with others. An avalanche of reclamation proceedings by individual customers is generally in order, and the results arrived at are too often unjust in the light of the true relations of margin customers between themselves and with the broker, their common agent. They were really all in the same boat, but by dint of superior diligence and ingenuity some swim while others sink. Like the two women grinding at the mill, one is taken and the other left, and for reasons so incomprehensible to lay minds that the unfortunate among the customers naturally regard the affair as a game of chance.

The whole controversy turns on the nature of margin transactions; and it is impossible to apply any legal principles or reasoning to the situation until the true relation between the broker and his margin customers has been determined in accordance with the facts and the intention of the parties.

Although the broker is allowed to mingle the stock purchased for his various margin customers, nevertheless, he is now in every jurisdiction in this country, including Massachusetts, required to have at all times in his possession or control, ready for instant delivery, sufficient stock to satisfy the just demands of all his margin customers.[7]

[7] Crehan *v.* Megargel, 235 Mass. 279, 283, 126 N. E. 477 (1920); Adams *v.* Dick, 226 Mass. 46, 53, 115 N. E. 227 (1917); Greene *v.* Corey, 210 Mass. 536, 548, 97 N. E. 70 (1912); Fiske *v.* Doucette, 206 Mass. 275, 284, 92 N. E. 455 (1910); Price *v.* Gover,

Nevertheless, in Massachusetts the general creditors have continued to insist on the contractual aspects of the claims of margin customers to the exclusion of all property rights except possibly in the case of securities deposited as margin, and to contend that such customers are merely creditors like themselves with provable claims. In the other important jurisdictions of this country, however, the customers are held to have property rights in the stock acquired by the broker on their account, in addition to the purely contractual rights created by the contract of agency.

The existence of property rights in the stock purchased under a contract of agency is not only compatible with the existence of contractual rights but is the direct result of the performance of the broker's obligation under the contract. It is a familiar principle that, when an agent acquires the title to property in pursuance of his employment, such property, either in law or in equity, belongs to his principal, and he cannot set up or claim an independent title in himself. Indeed, the prime object of the employment of a broker to buy stock is to acquire for the principal a property in stock.

Of course, the contract would not even be a contract of sale if it is made to cover a wager. But, if the contract is really one of agency made in good faith, nothing can defeat the legal or equitable title of the principal to any stock purchased on his order unless the broker has so dealt with the stock after its purchase that the principal's property rights therein are extinguished as a matter of law. In the absence of such legal difficulty, however, the legal or equitable title is in the customer if the contract is recognized as one of agency; and the Massachusetts courts, whatever may have been said in early cases, now hold that such is the nature of the contract.[8] It is true that Justice Loring, in *Rice* v. *Winslow*,[9] intimates that although the broker acts as agent in buying the stock, nevertheless the customer's property right therein is extinguished of necessity when the broker mingles the purchased stock with

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40 Md. 102 (1874); Douglas *v.* Carpenter, 17 App. Div. 329, 335, 45 N. Y. Supp. 219 (1897); Nourse *v.* Prime, 4 Johns. Ch. (N. Y.) 490 (1820); NEW YORK PENAL LAW, § 956; Skiff *v.* Stoddard, 63 Conn. 198, 26 Atl. 874 (1893); 1 DOS PASSOS, STOCK-BROKERS, 2 ed., 257; 16 COLUMBIA L. REV. 48. See also 19 HARV. L. REV. 529, note.

[8] Rice *v.* Winslow, 180 Mass. 500, 62 N. E. 1057 (1902); Hall *v.* Paine, 224 Mass. 62, 112 N. E. 153 (1916).

[9] 180 Mass. 500, 502, 503, 62 N. E. 1057 (1902).

stock of his own and of other margin customers; but such necessity depends entirely upon the nature of the property right acquired by the broker for his customer; and when the nature of this property right is defined and understood it will be seen that there is no necessity for the extinction of the customer's legal or equitable title.

To deny that margin customers have any rights of property in the stocks which they intend to purchase is not only a shock to them but is contrary to all principles of fair dealing. "At the inception of the contract it is the customer who wishes to purchase stocks," not the broker.[10] It is his judgment and not the broker's which is exercised in the selection of the stocks for purchase. He buys frequently for investment and speaks of the stocks as "my" stocks. He takes all the risks of the transaction and receives all the profits as well as suffers all the loss. To say that he has bought nothing and is a mere creditor is to defeat the very object for which he employs the broker as agent. Moreover, the broker who honestly performs his obligations is amply protected against loss by reason of the purchases so made and his private property and general estate are not imperilled. His ability to pay his private debts can be in no way impaired by the honest performance of his duties as agent for margin customers,[11] and it is the rankest sort of injustice to those customers to throw the property that they employed the broker to buy into the general pot in bankruptcy for distribution to all claimants, including the private creditors of the bankrupt. This, however, is the result unless the rights of margin customers are held to be something more than mere contractual claims; and the courts should, unless absolutely compelled on legal considerations, decline to perpetrate such an injustice.

The difficulties which seem to lie in the way of determining the legal relations of both customer and broker to the stock purchased may be traced almost wholly to the right of the broker to mingle the stock of his several customers and to pledge it for his own loans; and the claim has been made that this authority is so inconsistent with the retention of any property rights in the customer that in case of bankruptcy he must have recourse solely to his contractual rights, limiting his claim substantially to the amount of damage

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[10] Richardson *v.* Shaw, 209 U. S. 365, 377 (1908).

[11] Gorman *v.* Littlefield, 229 U. S. 19 (1913); Duell *v.* Hollins, 241 U. S. 523 (1916).

occasioned by the breach of the broker's contract to deliver the stock. Of course the customer may elect to treat the bankruptcy as equivalent to such a breach on the broker's part; [12] but he may with equal propriety elect not to abandon his property rights.

THE "MASSACHUSETTS DOCTRINE"

Is there a Massachusetts doctrine? It may be asserted that there is, but the doctrine certainly is not the one commonly ascribed to the courts of that state. The supposed doctrine is that margin customers have no property interest in stock purchased on their account, that the broker does not act as an agent or in any fiduciary capacity, and that the contract is an executory contract of sale between the broker as vendor and the customer as vendee. This supposition would be partially justified if one should begin with *Wood* v. *Hayes* [13] in 1860 and read the decisions down to *Chase* v. *Boston* [14] in 1902. But if he begins with *Crehan* v. *Megargel* [15] in 1920 and examines the cases back to *Greene* v. *Corey* [16] in 1912, he finds that the court has ceased even to cite the old cases for the *dicta* supposed to support the "doctrine" attributed to them and holds the broker to the strictest performance of his obligation as a fiduciary, first to purchase all stock when ordered by his margin customers,

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[12] *In re* Swift, 112 Fed. 315 (1901). When a customer proves his claim as a creditor under the contract with the broker, he thereby waives his other remedies, unless he expressly reserves them. Thomas *v.* Taggart, 209 U. S. 385 (1908). But the extraordinary contention has occasionally been made before referees in bankruptcy that, inasmuch as bankruptcy excuses a demand before proof of claim by a customer as a creditor and because he may so prove his claim without demand, therefore, whatever his previous rights of ownership may have been, the intervention of bankruptcy converts him at once into a mere creditor stripped of all rights of ownership, legal or equitable, in the stock carried for him by the bankrupt. This proposition, it is contended, is supported not only by *In re* Swift, 105 Fed. 493 (1900), but by Weston *v.* Jordan, 168 Mass. 401, 47 N. E. 133 (1897), and further by certain remarks in the opinion in Richardson *v.* Shaw, 209 U. S. 365, 383, 384 (1908). There is nothing whatever in any of these cases to support such a proposition, and in fact Mr. Justice Day in the latter case says (at p. 380), "We cannot consent to the contention of the learned counsel for the petitioner, that the insolvency of the broker at once converts every customer, having the right to demand pledged stocks, into a creditor who becomes a preferred creditor when the contract with him is kept and the stocks are redeemed and turned over to him."

[13] 15 Gray (Mass.) 375 (1860).

[14] 180 Mass. 458, 62 N. E. 397 (1902).

[15] 235 Mass. 279, 126 N. E. 477 (1920).

[16] 210 Mass. 536, 97 N. E. 70 (1912).

and afterwards to keep in his possession or control sufficient stock of each kind to satisfy the demands of them all. While he takes the legal title [17] he must keep the *res*, that is the body of the margin securities, intact; and the reader finds that the only perceptible difference at all fundamental between the true Massachusetts doctrine and the doctrine held elsewhere is that the Massachusetts court has put the broker in the position of a trustee holding the legal title and has strictly defined not only the *res* of the trust but his obligations with reference to it, while other jurisdictions regard the customers as legal tenants in common of property in the possession or control of their common agent. Further, the student will find that this view of the broker's relation to margin stocks does not conflict with the actual decision in any Massachusetts case, and squares more closely with the intention of the parties and the methods and customs of business than the view in other jurisdictions which involves at least two somewhat strained conceptions: (1) that shares of stock are essentially abstract units independent of the certificates,[18] and (2) that an anomalous relation of pledgor and pledgee exists between customer and broker.

It must be admitted that during the early period the Massachusetts court was apparently headed toward holding that margin transactions were as matter of law not at all what they purported to be but something different, yet the tendency is more apparent than real. So-called margin transactions so often cloaked a bet on the market without intention of actual purchase and sale, and so many brokers acted on the theory that notwithstanding the form of the contract and the entries on their books they were under

[17] Chase *v.* Boston, 180 Mass. 458, 62 N. E. 397 (1902); Hall *v.* Paine, 224 Mass. 62, 112 N. E. 153 (1916); Crehan *v.* Megargel, 235 Mass. 279, 126 N. E. 477 (1920).

[18] It is not quite true that the holder of a certificate representing shares in a corporation owns nothing but a certain number of abstract units independent of the certificate. He also owns the certificate; and such ownership will distinguish his shares from those of others so that he can identify them and perhaps be enabled to follow the proceeds if the shares or their proceeds are wrongfully in another's hands. To say that shares of stock of any particular kind are absolutely fungible in all circumstances is not true; but to say that margin stocks of any particular kind in the hands of a broker are absolutely fungible is true. The fungibility springs from the way the stocks are held and not from the nature of the property itself. Identification of their stocks is impossible between margin customers; but identification of his stock by one claiming that it has passed wrongfully into the hands of another is essential to any steps taken to recover it or its proceeds.

no legal obligation actually to buy and carry the stocks as ordered provided they could deliver the stocks when a customer paid up and demanded delivery, that the court may well have thought that there was in fact a mere wager involving neither agency nor property [19] or substantially an executory sale conditioned on payment.[20] At any rate the court was slow to accept a margin contract in stocks at its face value, and indeed could not do so while brokers recognized no legal obligation actually to purchase and to carry the stocks as ordered. Judge Lowell pointed this out in 1900.[21]

A review of the Massachusetts decisions shows the constant progress of the law in Massachusetts. Starting in 1860 with the idea that a stockbroker was virtually a dealer in stocks on his own account, he was treated in *Wood* v. *Hayes* [22] strictly as a seller of stock for future delivery on condition that the price was paid. The exact statement of Chief Justice Shaw was: "The contract was strictly conditional, to deliver so many shares upon the payment of so much money." This opinion that the relation was that of vendor and vendee was not at all required by the facts of the case, which was an action of tort for conversion, as Judge Lowell pointed out,[23] but it may be assumed fairly to reflect the current, if somewhat vague, conception at that time of the intended meaning of an order for stock from a broker to be delivered in the future, whatever the particular form of the contract. One must remember that *Wood* v. *Hayes* [24] "was decided in 1860, before the stockbroker was as familiar a figure as he is today, and before the law governing his calling was as well established." [25]

Covell v. *Loud*,[26] in 1883 restated the proposition in these words: "The contract was conditional to deliver the shares upon the payment of the money." In this case also the expression of opinion as to the nature of the contract was wholly unnecessary to the decision.

In 1897, in the case of *Weston* v. *Jordan*,[27] the court declined to reconsider the view supposed to be held in Massachusetts in conse-

[19] Chase *v.* Boston, 180 Mass. 458, 62 N. E. 397 (1902).

[20] Wood *v.* Hayes, 15 Gray (Mass.) 375 (1860).

[21] *In re* Swift, 105 Fed. 493 (1900).

[22] 15 Gray (Mass.) 375 (1860).

[23] *In re* Swift, 105 Fed. 493 (1900).

[24] 15 Gray (Mass.) 375 (1860).

[25] Skiff *v.* Stoddard, 63 Conn. 198, 214, 26 Atl. 874 (1893).

[26] 135 Mass. 41, 44 (1883).

[27] 168 Mass. 401, 47 N. E. 133 (1897).

quence of the two previous decisions because the facts of the case did "not call for such reconsideration of the general doctrine." The opinion was expressed, however, that the relation between customer and broker is not that of pledgor and pledgee, which, of course, implied that the title to the stocks remains in the broker until the time comes for delivery, and that the broker and customer are vendor and vendee merely, not agent and principal. If, as a matter of fact, the relationship of vendor and vendee was the true one, the broker, as the court remarks, was not "bound always to have on hand enough shares to meet the purchase," although such was the doctrine in New York and elsewhere. The subsequent recognition of that very obligation has proved to be the turning point in the later development of the law in Massachusetts. As long as the court clung, however, to the idea that a customer who bought stock from a broker for future delivery was dealing with the broker as a vendor of the stock so that the purchaser had only the contractual rights of a vendee, whatever the form of the contract, it necessarily followed that no intervening obligation rested on the broker to purchase the stock and to carry it for the customer's benefit until the time came for delivery. Judge Lowell in 1900, when he decided *In re Swift* in the United States District Court, drew attention to this lack of legal liability on the part of the broker actually to buy and carry the stock in the interim before delivery, although he acknowledged that brokers had a vague impression that they ought to do so.

Judge Lowell, of course, was attempting to follow the Massachusetts conception of the contract which controlled the case before him, but confessed himself considerably puzzled about the real opinion of the state court in view of the circumstance that such opinions as had been uttered were really *obiter dicta*, and also because both *Covell* v. *Loud* and *Weston* v. *Jordan* expressly worked out the same result both under the theory of vendor and vendee and the theory of agent and principal. He finally thought that the Massachusetts view, which was more or less justified by the practices of brokers at that time, inclined to the theory of vendor and vendee under a conditional contract of sale. That is why it was necessary in the case before him to determine when the broker was in default and the right of action by the customer accrued; and he finally held, and his decision was afterwards affirmed by the Circuit Court

of Appeals, that the broker would not be in default for failure to perform his conditional contract of sale until tender and demand by the purchaser or until the equivalent of such tender and demand; and, invoking the doctrine that a tender is unnecessary when it is impossible for the other party to perform, that bankruptcy practically created such impossibility so that an actual demand was excused. In holding that a demand and tender were necessary he expressly followed the case of *Weston* v. *Jordan*, where the court had stated that after the repeated demands and refusals shown in that case the purchaser had a valid ground of action against the broker "either for a breach of contract or for a conversion; it matters not which."

The idea that the form of the contract between broker and customer, which of course is plainly that of agency and not of purchase and sale, readily lent itself to an attractive method of betting on the rise and fall in price of stocks, strongly colors several of the Massachusetts decisions. Thus in *Chase* v. *Boston*,[28] decided in 1902, Chief Justice Holmes says that none of the features of the contract is decisive as to its character and that "a transaction in similar form might be a simple wager." Of course if the contract is a wager, stocks bought by the broker or which happen to be in his possession at any time are his property, not even subject to valid contractual demands; but, at the time of the decision, there had been in existence since 1890 a statute intended to curb in some degree the practice of making wagering contracts with reference to the rise and fall of stocks by giving the so-called customer a right of action to recover money or property paid to or deposited with the so-called broker, and actions had already been brought to enforce the remedy provided.[29] "Bucketing" had not at that time been made a crime, as it was later in 1907,[30] and the court was excusably slow to see that the remedy of the statute and the language in which that remedy was couched really implied an obligation on the part of the broker to carry out in good faith the orders of his customers for the purchase of stock and to hold or carry the stock when purchased; in other words, that the statute implied the true relation was that of agency. It cannot be reiterated too often

[28] 180 Mass. 458, 62 N. E. 397 (1902).
[29] Lyons *v.* Coe, 177 Mass. 382, 59 N. E. 59 (1901).
[30] STAT. 1907, c. 414.

that when the obligation of the broker under contracts made in good faith is recognized to be that he must actually purchase and hold or carry the stock until the time comes for delivery, the whole foundation falls from under the supposed doctrine of such cases as *In re Swift*, *Weston* v. *Jordan*, *Covell* v. *Loud*, and *Wood* v. *Hayes*.

The pressure of the statute was felt in *Chase* v. *Boston*, but the court explained that its language was used in a popular sense "and that the broker is not treated there as a party to a contract to buy or sell but as one employed to buy or sell." Some such explanation was necessary to make the opinion verbally consistent with *Rice* v. *Winslow*, reported in the same volume.[31]

The point at issue, however, in *Chase* v. *Boston* was simply whether the broker who is carrying stocks for margin customers holds the legal title for purposes of taxation; and the court said that he does. In view of the later cases, *Chase* v. *Boston* stands only for the proposition that the broker in margin transactions acquires the legal title of the stock purchased by him on the orders of customers. Nothing is said in that case as to the obligation of the broker actually to purchase the stock and to hold it in his possession or control until delivery is demanded. Of course, the decision implies that the court recognized no such obligation, yet in *Rice* v. *Winslow*, which was an action by a customer to recover from a broker under the wagering statute of 1890, Justice Loring found himself bound to say that in making the initial purchase of stock to be carried on a margin the broker's "relation to the customer in buying the stock is that of an agent," because otherwise he would not come within the language of the statute which provides for recovery when one "employs another to buy or sell for his account."

Rice v. *Winslow* marks important progress in the Massachusetts law. (1) In the ordinary margin transaction the customer is held not to purchase of the broker. The case did not come "within the first clause [of the statute of 1890] because it is a case where the plaintiff did not buy of the defendant, but where he employed the defendant to buy." (2) It is distinctly recognized that the initial relationship in margin transactions is that of agency.

These two propositions are an absolute departure from the doctrine of *Wood* v. *Hayes*, which is that there is no agency and that

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[31] 180 Mass. 500, 62 N. E. 1057 (1902).

the relationship is that of buyer and seller. The court does not undertake in *Rice* v. *Winslow* to pass upon the obligations of the broker after the initial purchase to hold or carry the stock. The only suggestion made in regard to that subject is that the broker, having the right in some respects to treat the shares so bought as his own and to mingle them with other stocks, is authorized, like a factor in the case of money received from the sale of goods for several principals, to substitute his credit for the stock itself; so that the case is cited for the proposition that the initial purchase is made by the broker as agent of his customer but that, owing to "the necessities of the business of the agent," he becomes a debtor to the customer for the stocks.

The way in which a broker conducts his business prevents him from keeping the margin stocks acquired for each customer apart from other stocks of the same kind, and requires the use of the margin stocks *en bloc* or otherwise at the discretion of the broker as pledges for his own loans. These are the "necessities of the business" which the learned justice undoubtedly had in mind. But neither the right to mingle the stocks nor the right to pledge them is incompatible with the retention of property therein by the customers.

In jurisdictions outside Massachusetts a margin customer has a legal property like that of a depositor in a grain elevator who "may have a property in grain in a certain elevator although the keeper is at liberty to mix his own or other grain with the deposit and empty and refill the receptacle twenty times before making good his receipt to the depositor concerned";[32] and in such jurisdictions the margin customers are, therefore, legal tenants in common of the margin stocks of each particular kind. In Massachusetts the situation now appears to be the same except that the interest of the customers is equitable instead of legal, because the legal title is in the broker. So that in all jurisdictions the stocks in the hands of the broker may be absolutely fungible and at the same time belong, either in law or in equity, to the margin customers. And it is equally true that the broker's right to pledge the margin stocks furnishes no cause for the conversion of the relation between broker and customer into that of debtor and creditor.

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[32] Holmes, J., in Sexton *v.* Kessler, 225 U. S. 90, 98 (1912).

In *Chase* v. *Boston*[33] (a suit between the same parties as in the earlier case of the same name), the right to pledge stocks kept in separate envelopes as the property of each customer was held not to affect the customer's title.[34] In view of these considerations, therefore, none of the "necessities of the business" of the broker has the effect suggested by Justice Loring.

In 1902, then, it had been settled that the broker at the start is an agent. It had been suggested that after the initial purchase of the stock he substituted his credit for the stock and the relationship thereafter was that of debtor and creditor. It had also been declared, perhaps decided, that the broker is the holder of the legal title, and therefore is not a pledgee. And the question of the broker's obligations with respect to carrying stock and having sufficient on hand to meet all demands had been left open with no intimations except those made by Justice Allen in *Weston* v. *Jordan* and by Judge Lowell in the case of *In re Swift*.

We now pass to the later Massachusetts cases. Justice Rugg in *Fiske* v. *Doucette*,[35] in 1910, speaking of the title to stocks carried on margin and the question whether the broker is a pledgee according to the New York law, puts the case no more strongly than this: "In this regard the law of New York *probably* differs from our own"; but in *Hall* v. *Paine*,[36] decided in 1916, the same judge, then chief justice, said: " . . . the rule in this Commonwealth is that, in the ordinary relation between customer and broker where the latter carries stocks on margin, the legal title is in the broker, *Chase* v. *Boston*, 180 Mass. 458, differing in this respect from that of some other jurisdictions, *Gorman* v. *Littlefield*, 229 U. S. 19." In the later case of *Crehan* v. *Megargel*,[37] decided in 1920, Justice De Courcy says:

> "In accordance with the long established rule of law in this Commonwealth, the legal title to the stocks carried on margin was in the brokers, as between them and their customer; and this is true alike of the stocks bought on margin by the defendants, and those deposited with them under the circumstances here disclosed . . . "

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33 193 Mass. 522, 79 N. E. 736 (1907).

34 See also JONES, COLLATERAL SECURITIES, 3 ed., § 153.

35 206 Mass. 275, 281, 92 N. E. 455 (1910).

36 224 Mass. 62, 72, 112 N. E. 153 (1916).

37 235 Mass. 279, 282, 126 N. E. 477 (1920).

It appears to be settled in Massachusetts, therefore, that the legal title to stock deposited or carried is in the broker and not in the customer. This proposition carries with it the further proposition that in Massachusetts the customer and broker do not and cannot stand in the relation of pledgor and pledgee. In this respect, as Chief Justice Rugg says, the Massachusetts law differs from that in other jurisdictions, and it may be added that it wisely differs, because to hold that the broker has the full legal title to all stocks which he purchases on margin for his various customers conforms better with the facts and permits a clearer conception of his true relationship to his customers than the somewhat strained conception entertained in other jurisdictions that each customer has some legal right of property which follows the stocks in the broker's hands through all the transactions short of actual sale.

But to say that the legal title to all stocks carried on margin is in the broker is far from saying that the customer has no rights in the nature of property in the stocks. *Furber* v. *Dane* [38] furnishes, perhaps unintentionally, a powerful argument in support of a property right of some kind. One of the plaintiffs was allowed in equity to recover stock he had deposited as margin. It was conceded that brokers treat stock so deposited exactly like stock purchased and carried on margin. This means that brokers have and exercise the same rights to mingle and to pledge stocks deposited as margin that they have and exercise in the case of stocks purchased and carried on margin. If these rights are inconsistent with the existence of any property rights of the customer in the one case they must be in the other. In both, the customer's proprietary interest is extinguished, if at all, at the moment the stocks pass into the broker's possession with full power to mingle and to pledge them; and once extinguished, it is forever gone unless newly created by act of the parties. The fact that the identical certificates deposited as margin may turn up somewhere is of no consequence in the determination of the customer's present interest. If several persons contributed money to a trust fund which was to be held and subsequently divided among them, the final division would not be affected by the presence of marked bills paid in by one of them. If, therefore, *Furber* v. *Dane* establishes that a property

[38] 203 Mass. 108, 89 N. E. 237 (1909).

right which may be enforced in equity by the customer persists in the case of stocks deposited as margin, in spite of the broker's authority to mingle and to pledge them, then the same principle applies to stocks purchased and carried on margin. The conception of an undivided equitable right of property is identical to both.

The law in Massachusetts, therefore, comes down to this: that the broker must be a trustee of the stocks which he is carrying for his margin customers and that each of his customers has an equitable interest or title in his undivided proportionate part of all the stock of any particular kind in the possession or control of the broker. The Massachusetts court has stopped short of saying in so many words that each customer has such an equitable property or interest; but it has in recent years defined with great particularity the duties and obligations of the broker with reference to the stock, and these duties and obligations so defined are precisely those which would be required of the broker as trustee. The definition of his duties and obligations fixes his character; it comes to the same thing if you first define the rights and obligations of a person with reference to a particular matter and then find that you have described a trustee; or first describe him as a trustee and then say that because he is a trustee he has precisely these same rights and obligations. The character of legal relationships is determined by the rights and obligations incident to them; and when we find a man subject to all the rights and obligations of a trustee we may as well call him so. What, then, are the rights and obligations now recognized as resting on a broker who has purchased and is carrying stock on a margin?

It is of interest that the formula expressing the obligation of a broker to keep intact the body of stocks required to meet the demands of margin customers was developed in cases arising under statutes passed in 1890 and 1901 [39] providing a remedy against brokers for losses suffered under wagering contracts. By the later statute brokers were allowed to show in defense that they actually purchased or sold the stock as ordered and in 1910 it was held, in *Fiske* v. *Doucette*,[40] that the defense permissible under the statute was not made out on the evidence submitted "unless by reason of

[39] STAT. 1890, c. 437; STAT. 1901, c. 459.

[40] 206 Mass. 275, 284, 92 N. E. 455 (1910).

the purchase on the stock exchange the broker or his agent has within his immediate control certificates of stock at all times ready to deliver to the plaintiff upon demand, or in the case of sales, like certificates for delivery to a purchaser." This the learned justice said was the implied doctrine of the previous case of *Rice* v. *Winslow*.[41] "The dispute there arose between the purchaser and the stockbroker, and it was assumed as the basis of the opinion that the broker had in his manual possession or immediate and instant control certificates of stock to meet upon demand every share purchased or sold for the account of his customer."

Justice Sheldon, in *Greene* v. *Corey*,[42] an action brought on the same ground that recovery was sought in *Fiske* v. *Doucette*, said:

> "The broker, to put himself right in such a case as the one now before us, must show that he has under his control, free from the just demands of other customers and available for delivery to the customer whose case is in question, the stocks of which that customer upon payment will be entitled to demand delivery."

Obviously compliance with the rule as stated by Justices Sheldon and Rugg requires the broker not only to purchase but to keep a body of stock of each particular kind in his possession or control to meet the demands of all the customers.

Admittedly the broker has the legal title, but he is subject to the obligation above stated. In other words, all the stocks of any particular kind in his possession or control are a trust property or *res* held for the benefit of the customers interested in that particular kind. The broker, according to the rule laid down, has no right to deplete the trust property. True, he has a power of substitution, but he must keep the property intact as far as the number of shares is concerned. And each customer interested is on the same footing as each other customer. Each is entitled to the immediate delivery of his share of the trust property when he complies with the conditions which, of course, are that he shall pay the amount of the advances and charges of the trustee. The only known term that will describe the relation of the broker to the customers in these circumstances is that of trustee. It is true that he started out as an agent to acquire the property which is the subject matter

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[41] 180 Mass. 500, 62 N. E. 1057 (1902).

[42] 210 Mass. 536, 548, 97 N. E. 70 (1912).

of the trust; but after he has acquired it he must become a trustee of it, if he is subject to the obligations which the law, in the opinion of the court, has laid upon him. There is nothing peculiar to this situation distinguishing it from any other where an agent has acquired the legal title to property in behalf of his principal. He is necessarily trustee of the property, and his principal is the equitable owner.

If the broker is trustee for each group of customers for whom he is carrying a particular stock on margin, he is naturally required to exercise the care and fidelity of a trustee in respect to the trust property, taking into account the purposes for which it is held and the powers which the customers have conferred upon him. There are no particular degrees of fidelity and good faith in such a case as this. The fidelity and good faith required of the broker as an agent differ in no wise from those required of him as a trustee. We should expect the court to impose upon the broker in such circumstances all the obligations which are appropriate to his fiduciary position. Accordingly he is bound to deal with the trust property without self-interest. In *Rice* v. *Winslow*,[43] Justice Loring says that "in the purchase of the stock he owes to his customer the same duty, that he owes to him, where he is employed to buy stocks, which are to be taken and paid for by the customer in place of being taken and paid for by the broker for the customer." This language is quoted with approval by Chief Justice Rugg in *Hall* v. *Paine*,[44] and he adds, "For breach of that duty by the broker a cause of action arises and, so far as the measure of damages goes, it is not of consequence whether the action is in tort for conversion or for breach of contract. *Richardson* v. *Shaw*, 209 U. S. 365, 382. Moreover, in this respect it matters not whether the stock were bought on margin or deposited with the broker. *Furber* v. *Dane*, 203 Mass. 108, 115." When the broker is ordered to sell stocks that are carried on margin the learned Chief Justice says that

> "while he may transfer a good title to a third person, [he] cannot purchase for himself, at least not without the full knowledge and assent of his principal. A broker's obligation to his principal requires him to secure the highest price obtainable, while his self-interest prompts him

[43] 180 Mass. 500, 502, 62 N. E. 1057 (1902).
[44] 224 Mass. 62, 72, 73, 112 N. E. 153 (1916).

to buy at the lowest practicable price. The law does not trust human nature to be exposed to the temptations likely to arise out of such antagonistic duty and influence. . . . The converse of the rule is equally binding, that an agent to buy cannot sell his own goods to his principal without the latter's knowledge and assent. . . . This rule is so deeply grounded in fundamental reason that no custom or private rule can override it."

The foregoing language is equally applicable to agent or trustee. It matters not by what name he may be called, the fiduciary character of either requires the exercise of precisely the same fidelity to the interests of the beneficiary or principal. The only difference, which has nothing to do with the character of the obligation, is that in the particular case of a broker as agent dealing with margin stocks he is the holder of the legal title and is, therefore, strictly speaking, a trustee with respect to the stocks. Decisions by the Massachusetts court such as those above quoted remove entirely from the field of discussion the question whether or not a broker purchasing or selling or carrying stocks on a margin is acting in a fiduciary capacity.

The Massachusetts court has also discussed the subject matter of the trust held by the broker for each group of his margin customers interested in a particular stock. Chief Justice Rugg in *Adams* v. *Dick*,[45] speaking of the defense set up by the broker in an action under the statute to recover money paid as margins, said:

"The judge found that the defendants had only five sources from which to comply with possible demands upon them for the delivery of stocks sold on the plaintiff's orders or for delivery to the plaintiff of stocks bought on his orders, viz.: stocks actually in the hands of the defendants, stocks pledged by the defendants as collateral for loans made to them from banks, stocks pledged by the defendants to other brokers, stocks lent by the defendants to other brokers, and the obligations of persons who had sold stock short through the defendants without furnishing them with the certificates; and that, unless all these sources complied with the law, the defendants were not ready to respond to such demands. Manifestly stock in actual possession was available to the defendants. The plaintiff concedes that stocks pledged to the banks also were available. See *Chase* v. *Boston*, 180 Mass. 458. Without discussing whether stocks pledged or lent to other brokers were available

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[45] 226 Mass. 46, 53, 54, 115 N. E. 227 (1917).

to the defendants, it is plain that the obligations of persons who had sold stock short, to deliver certificates of such stock on demand, utterly fails to constitute stock in possession. As shown by the transactions with the plaintiff, short sales at most result in contracts which neither party expects to carry out by actual delivery. But even if there is a purpose to carry them out by an actual delivery of the certificates of stock, a contract for the delivery of stock is not equivalent, in any just sense, to possession of stock. The defendant failed to show actual purchases and sales as defined in *Fiske* v. *Doucette*, 206 Mass. 275."

Evidently at the outset the court did not perceive that the wagering statute of 1890 inferentially defined or affected the relation between brokers and their customers, but felt that it imposed an arbitrary *duty* to execute the customer's orders.[46] The later language of Chief Justice Rugg in *Hall* v. *Paine*,[47] however, quoting *Rice* v. *Winslow*,[48] when he speaks of the "duty" owed the customer instead of making use of the word *obligation* has no special significance. The broker purports to be and to act as an agent, and it makes no difference how his obligations are defined or what remedies are provided for breaches of them. If the broker is in duty bound, whether because of statute or of decisions or of both, to do those things which an agent should do under his contract, his relationship to the other party is thereby fixed. A statute requirement that a broker should deposit funds collected for customers in a separate account in a bank standing in his name as trustee, when complied with, fixes the relation between the broker and the beneficiaries of the funds deposited. The customer would be held to have rights in the funds deposited in such manner from the moment the deposit was made.

While it is true that the recognition of the obligation of brokers to keep intact the body of margin stocks developed from statements of the kind of evidence that would sustain the defense of actual purchases or sales provided by the statute of 1901 [49] in actions brought under the statute of 1890 [50] to recover money or

[46] See the concluding statements in Chase *v.* Boston, 180 Mass. 458, 460, 461, 62 N. E. 397 (1902).

[47] 224 Mass. 62, 72, 73, 112 N. E. 153 (1916).

[48] 180 Mass. 500, 502, 62 N. E. 1057 (1902).

[49] STAT. 1901, c. 459.

[50] STAT. 1890, c. 437.

securities paid or deposited by customers in bucketing transactions,[51] the Massachusetts court in the recent case of *Crehan* v. *Megargel* [52] did not hesitate in transactions not bucketing in character to hold the brokers liable for a breach of contract unless they proved "that they had in their possession or control at all times, available for delivery to the plaintiff, the stocks which they purported to be carrying for him." This decision is, of course, directly contrary to the *dictum* in *Weston* v. *Jordan*[53] that a broker was not "bound always to have on hand enough shares to meet the purchase," although such was the doctrine in New York and elsewhere, and on that subject the decision ranges Massachusetts squarely with other jurisdictions.

The real "Massachusetts doctrine," therefore, so far as there is a doctrine peculiar to that state, seems clearly to be that the broker takes the legal title of stock deposited or purchased and holds it as trustee for his margin customers under all the obligations growing out of that relation.

Margin Stocks in Bankruptcy

At least one thing is clear about margin stocks in the bankruptcy of the broker. If the stocks belong to the customer, whether in law or in equity, it matters not which, the general creditors have no claim upon them. In bankruptcies outside Massachusetts they have been kept apart from the general assets in a multitude of cases which are beyond the scope of this article to examine.[54] But the federal courts in bankruptcy cases controlled by Massachusetts law have hitherto acted in conformity with the supposed doctrine of that state, holding margin customers to be creditors merely who

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[51] Barrell *v.* Paine, 236 Mass. 157, 128 N. E. 17 (1920); Adams *v.* Hayden, 236 Mass. 454, 128 N. E. 798 (1920); Zembler *v.* Fitzgerald, 234 Mass. 236, 125 N. E. 299 (1919); Houghton *v.* Keveney, 230 Mass. 49, 119 N. E. 447 (1918); Chandler *v.* Prince, 214 Mass. 180, 100 N. E. 1029 (1913); s. c., 217 Mass. 451, 105 N. E. 1076 (1914); s. c., 221 Mass. 495, 109 N. E. 374 (1915).

[52] 235 Mass. 279, 126 N. E. 477 (1920).

[53] 168 Mass. 401, 47 N. E. 133 (1897).

[54] *In re* Solomon & Co., 268 Fed. 108 (1920); *In re* Wilson, 252 Fed. 631 (1917); *In re* James Carothers & Co., 182 Fed. 501 (1910); s. c., 192 Fed. 693 (1911); *In re* A. O. Brown & Co., 171 Fed. 254 (1909); s. c., 183 Fed. 861 (1910); *In re* T. A. McIntyre & Co., 181 Fed. 955 (1910); M. S. Hagar, "The Bankruptcy Law as Applied to Stockbrokerage Transactions," 30 Yale L. J. 488.

may prove their claims for a breach of the contract to deliver stocks upon demand.[55] The time seems to have come to declare that this doctrine, if it ever existed, is obsolete.

Margin customers may, of course, elect to prove their claims as creditors, treating the bankruptcy as a breach of contract to deliver stocks;[56] but such an election should not work to the advantage of the general creditors at the expense of the other margin customers who do not so elect. It is one of the purposes of this article to draw attention to certain important consequences of the community of interest of margin customers derived from their employment of a common agent which have not received the study they deserve. The familiar and well-settled principles of law involved are those governing the mutual relations of parties in such a situation, and bankruptcy simply furnishes occasion for their application. Bankruptcy by itself alters the nature of neither contract nor property.

The origin and reason of margin transactions may be found in the apparent need of some method of buying stocks largely on credit. Stockbrokers have undertaken to perform that service, supplying a part, often a large percentage, of the necessary funds and protecting themselves from loss by the retention of the securities purchased and requiring a certain proportionate payment or the deposit of other securities by their customers. The business is necessarily done on a considerable scale and the success of the broker depends upon the extent of his clientage. The larger the clientage the more money must be advanced by the broker for the purchase of stocks, but being a broker and not a banker he soon finds that the capital necessary far outruns his resources without loans from financial institutions.[57] Of course it is natural that the securities purchased for customers and those deposited by them should be used as pledges for the money he borrows in the business; and it is obvious that, having a large number of customers, many of whom are ordering him to purchase stocks of the same kind, it is impracticable for him to undertake, either in the original purchase or in the subsequent

[55] *In re* Swift, 105 Fed. 493 (1900); s. c., 112 Fed. 315 (1901); *In re* Gay & Sturgis, 251 Fed. 420 (1918).

[56] *In re* Swift, 105 Fed. 493 (1900); s. c., 112 Fed. 315 (1901).

[57] Skiff *v.* Stoddard, 63 Conn. 198, 230, 26 Atl. 874 (1893).

hypothecation of the stock, to keep any particular certificates or securities of any kind apart from the general mass as the property of particular customers.

Now this situation is well understood and, even without the express stipulations generally insisted on by the broker, customers may well be deemed to authorize purchases and pledges to be made in the manner indicated.[58] This brings us to the important and significant fact, frequently overlooked, that the whole body of margin customers, employing the broker as their common agent under identical contracts, necessarily constitutes a class or group in which the rights of the individual members are dependent to a large extent upon the rights of all other members and, at any rate, ought not to be enforced by any one of them without due regard to the rights of the others.

The property, therefore, held by the broker for the class of persons comprising all his margin customers consists in the first place of all the securities bought for the members of that class. To this body of securities should be added, whenever custom or contract requires, the securities deposited by the margin customers. For instance, in Boston it is the custom of brokers to treat stocks deposited as margin in precisely the same way as stocks bought and carried on margin.[59]

A most important consequence follows. Since the broker has been given, either by custom or by express contract, the right to hypothecate, at his discretion, any or all of the securities so held by him for the purpose of providing himself with the necessary funds to carry on the business in behalf of all his margin customers, a loan procured by him for which he has pledged any of these securities is a charge upon the whole body of securities, and in case of loss occasioned by an excessive pledging by the broker, that loss, on the familiar principle of contribution or general average, must be borne *pro rata* by all the customers in proportion to the value

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[58] Skiff *v.* Stoddard, 63 Conn. 198, 219, 26 Atl. 874 (1893); 1 Dos Passos, Stockbrokers, 2 ed., 254; 19 Harv. L. Rev. 529, n. See also Nourse *v.* Prime, 4 Johns. Ch. (N. Y.) 490 (1820); Lawrence *v.* Maxwell, 53 N. Y. 19 (1873); Oregon Co. *v.* Hillmers, 20 Fed. 717 (1884).

[59] Hall *v.* Paine, 224 Mass. 62, 73, 112 N. E. 153 (1916); Crehan *v.* Megargel, 235 Mass. 279, 282, 126 N. E. 477 (1920); Furber *v.* Dane, 203 Mass. 108, 115, 89 N. E. 227 (1909).

of their respective holdings.[60] The mind should be permitted to dwell upon this proposition because it is founded upon those equitable principles always sought to be applied where there is a community of interest, and prevents unjust results which are sure to follow in greater or less degree an attempt to work out the rights of individual customers in total or partial disregard of their essential community of interest arising from the fact that each one of them has voluntarily become a member of the class of persons for whom their common agent is doing business on margin.

There are but two causes for loss to margin customers occasioned by the acts of their common broker that need be considered. The first is an excessive use of the margin securities by the broker for the purpose of procuring loans to himself; and an excessive use may be defined in general to consist in loans aggregating more than the amount owed by customers for the purchase of securities. The second cause of loss is due to the failure of the broker to keep intact the body of securities held for the margin customers. How loss from the first cause should be distributed has just been stated. Loss from the second cause must be distributed according to the same principle applied to different facts.

Owing to the fact that different customers are interested in different securities it cannot be said that securities of all kinds are so mingled in the hands of the broker that the failure of the broker to keep intact the amount of securities of any particular kind should affect the entire body of margin customers. If, for instance, the broker should have in his possession or control 1000 shares of United States Steel stock to meet the demands of all the customers interested in that particular stock and in fact has but 500 shares when overtaken by bankruptcy or other financial catastrophe, the loss is necessarily limited to the group of customers entitled to shares of that kind, and they must bear it *pro rata*. In other words, while the entire body of customers have a common interest and have given identical authority with respect to the loans procured by the broker on such stocks as he may select at his discretion, they have not a common interest in the particular kinds of stock held by the broker. Each customer exercises his own judgment

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[60] Skiff *v.* Stoddard, 63 Conn. 198, 231, 26 Atl. 874 (1839); *In re* T. V. McIntyre & Co., 181 Fed. 955 (1910).

successfully or unsuccessfully with regard to the advantages of the particular securities in which he authorizes the broker to deal for him, but inasmuch as the broker is at liberty to hold the securities of any particular kind in such form as he pleases with no attempt to divide them between the customers entitled to them, there must be an equitable adjustment of the loss in the event of a shortage in the amount of the securities so held. Therefore, applying the same principle of contribution, each customer entitled to a particular stock must, in the event of insufficiency of stock of that kind to meet the demands of all the customers entitled to it, contribute to or bear his share of that loss in common with those in like case.[61] The application of the principle stated works exact justice under familiar doctrines of equity and eliminates the tendency toward the unjust and often absurd results, not comprehensible to laymen, arrived at by technical legal reasoning which ignores the essential community of interest between those who are in precisely like circumstances.

The courts in this country are now in agreement that the broker is under an obligation to keep intact the body of securities which he holds for margin customers whether purchased for them or deposited by them. It has already been stated that by common practice securities deposited as margin are merged with and treated in precisely the same manner as securities purchased. But keeping the securities intact does not mean that the original certificates need in any case be retained. The absolute right of the broker to substitute other certificates of like kind and of the same aggregate amount is unquestioned.[62] This right or power of substitution makes it clear that neither the broker nor his customers have any intention of preserving the identity of securities in margin transactions for the purpose of distinguishing between customers as to

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[61] *In re* Wilson, 252 Fed. 631 (1917); Duel *v.* Hollins, 241 U. S. 523 (1916); Skiff *v.* Stoddard, 63 Conn. 198, 26 Atl. 874 (1893).

[62] Duel *v.* Hollins, 241 U. S. 523 (1916); Gorman *v.* Littlefield, 229 U. S. 19 (1913); Sexton *v.* Kessler, 225 U. S. 90 (1912); Richardson *v.* Shaw, 209 U. S. 365 (1908); Chase *v.* Boston, 180 Mass. 458, 460, 62 N. E. 397 (1902); 1 Dos Passos, Stockbrokers, 2 ed., 187, 251. The intention of the broker to replenish the body of margin stocks by purchase of new stocks to take the place of those which he ought to have is inferred from the kind of stocks purchased, and is distinguished from the replenishment of a trust account in a bank in which the trustee has mingled his own funds. *In re* Leavitt & Grant, 215 Fed. 901 (1914).

their property rights. Such identity as may exist in any particular case is either accidental or for some incidental purpose, such as to enable the broker to keep check on the amount of loans procured by him as compared with the amounts owed him by customers. Where attempts are made to follow such pseudo identity for the purpose of determining the rights of individual customers absurd and generally unjust results are bound to follow. Attempts in bankruptcy cases to act on the supposed doctrine of *Furber* v. *Dane*,[63] which was not a case of bankruptcy, have led to extraordinary inequalities and injustices for the reason that emphasis has been placed upon the identity of securities held by the broker in margin transactions to the utter exclusion of the fundamental conception of such transactions which has been above stated and which is, in short, that persons selecting a common agent for the purpose of dealing in stocks on margin thereby become members of a group who have authorized their agent first to mingle indistinguishably all the margin securities of the same kind and secondly to hypothecate any he selects from all kinds.[64]

The general propositions are, therefore, that losses occasioned by excessive pledging, as defined above, should be apportioned *pro rata* among all the margin customers; while losses caused by failure to maintain the amount of any particular kind of stock should be apportioned among the margin customers entitled to that kind of stock.

Stock pledged by the broker to banks for his own loans is held by them under the ordinary conditions of a common-law pledge, and the identity of the stock so pledged is not lost.[65] In Massachusetts the broker has the legal title to the stock which either stands in his own name or, as is generally the case, has been endorsed to him in blank. When he pledges it to the bank, the bank probably acquires the legal title, but this is not incompatible with a pledge of stock. "In such case, although the pledgee receives

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[63] 203 Mass. 108, 89 N. E. 227 (1909).

[64] There are, of course, many cases in which brokers have wrongfully used securities entrusted to them, and in those cases the ordinary equitable remedies require some identification of the property by those seeking to recover it. 22 HARV. L. REV. 133 n.; Thomas *v.* Taggart, 209 U. S. 385 (1908).

[65] But if the pledgee surrenders other certificates of stock of the same amount and kind as the certificates originally pledged, the pledgor could recover at most only nominal damages, except in unusual circumstances. Atkins *v.* Gamble, 42 Cal. 86 (1871.)

the apparent legal title, the general property in the security remains in the pledgor"; and "it is immaterial in this respect whether such transfer appears to be absolute or is expressed to be made as security." [66] In other jurisdictions the bank as pledgee is in the same position as in Massachusetts, but the general property of the pledged stock is really in the customers and not in the broker, although as between the bank and the broker the latter is deemed to be the pledgor.

What has been said up to this point shows the principles upon which the broker's entire interest in stocks which are carried on or deposited as margin should, in case of loss, be apportioned among the margin customers. Of course, if there has been no overpledging of stocks, that is to say if the loans made to the broker secured by pledges of the stock are not in excess of the amounts due from margin customers, the latter amounts when collected will redeem the pledges or, if the stocks are sold, the sums so received will be sufficient not only to satisfy the banks but also to pay over to the customers the full value of their interest in the stocks. In such case money is substituted for the stocks themselves, but the principle is the same.[67] And so in like manner, if there comes into the possession or control of the trustee in bankruptcy a sufficient number of shares of the stocks of each kind to satisfy the demands of margin customers, there will be no controversy with the general creditors and division of the stocks or their proceeds may be made without difficulty.

We now come to the question how the conflicting interests of margin customers and general creditors shall be adjusted in case of loss.

1. When there is a deficiency in the number of shares of stock of any particular kind as they come into the possession or control of the trustee in bankruptcy, the margin customers have no rights against the general assets of the estate such that the trustee is obliged to purchase by use of the general assets sufficient shares to make good the deficiency. Although the bankrupt was at all times bound to do so,[68] that obligation does not pass to the trustee,

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[66] JONES, COLLATERAL SECURITIES, 3 ed., § 153.

[67] *In re* James Carothers & Co., 182 Fed. 501 (1910); s. c., 192 Fed. 693 (1911).

[68] Richardson *v.* Shaw, 209 U. S. 365 (1908); Gorman *v.* Littlefield, 229 U. S. 19 (1913).

because to discharge it requires to some extent that personal discretion, judgment, and skill which the bankrupt himself was employed to exercise. The trustee cannot perform the functions of a broker when they involve services requiring to any degree the personal judgment of the broker. Fiduciary obligations of that sort are necessarily suspended by bankruptcy; at least, the trustee is not subject to them because he cannot perform them.

Here, however, we come to the important question as to when a deficiency for the purpose of proceedings in bankruptcy exists, and if so, to what extent. If all the margin customers having an interest in any particular kind of stock make their claims in the bankruptcy proceedings relying upon their property rights in the stock, then there is a deficiency if there are not sufficient shares of that kind of stock to satisfy the demands of all in that group of customers. It is frequently the case, however, that many of the customers, either by inadvertence or preference, do not insist on their property rights but prove their claims as general creditors. In such case they are said to waive their property rights in the stock and to rely wholly upon their claims arising out of contract, as they have a perfect right to do. The trustee in bankruptcy has precisely the same choice as to the course to pursue. If he deems it to be for the advantage of the estate he may tender the stock and demand payment of the amount due from the customer, but he must do so within a reasonable time.[69] When, however, it is definitely settled that the customer has elected, and the trustee has not exercised his election to the contrary, that he will rely upon his contractual rights as a creditor, he then drops out of the group of margin customers to which he belongs, and the *pro rata* shares of the remaining members in the case of a deficiency become so much the larger.

In *Gorman* v. *Littlefield*[70] the petitioner claimed 250 shares of a copper stock; 350 shares of that kind of stock came into the possession of the trustee. As to this stock no other claim had been filed with the receiver or with the trustee and the time for filing such claims had expired. Gorman was allowed to recover to the extent of his 250 shares, as there was more than sufficient stock to satisfy him as the only claimant.

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[69] *In re* Swift, 112 Fed. 315 (1901).

[70] 229 U. S. 19 (1913).

In *Duel* v. *Hollins*[71] two claimants appeared, who together had bought 150 shares of a certain kind of stock. The trustee in bankruptcy, however, had only 100 shares. It was held that the two margin customers who had filed proper claims should divide the 100 shares in proportion to their respective claims.

Therefore, the extent of the deficiency in any kind of stock must be determined upon the face of the claims as presented to the trustee and, if it then appears that there is a deficiency, those margin customers making proper claims are entitled to their *pro rata* shares.[72]

It will in most cases, however, appear that the election of certain of the margin customers to prove their claims as creditors relying on their contractual rights will deplete the general assets of the estate to the extent of their dividends. Ought their election while enhancing the *pro rata* shares of the remaining margin customers to work any loss to the general estate? It seems just and equitable that the amount of such dividends be deducted in some appropriate way from the stock or its proceeds claimed by the remaining customers. In other words, the election of certain of the margin customers to press their contractual rights as ordinary creditors ought not to work to the advantage of the other customers claiming their stock at the expense of the general assets.

2. A much more difficult question arises when there has been an excessive pledging by the broker of stocks carried on or deposited as margin in the manner which has been above defined. The issue is whether the trustee in bankruptcy ought to pay the excess out of the general assets of the estate.

There is strong argument that he should do so to the extent that it is necessary to redeem stocks in which margin customers have sought to enforce their property rights. If he does so, he is to that extent only paying a debt of the bankrupt. This is far different from using the general funds to purchase stocks when there is a deficiency. The payment from the general assets of any part of the debt due to the banks is in no way a preference, either to the banks or to the margin customers whose stocks would thereby be

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[71] 241 U. S. 523 (1916).

[72] The apportionment is determined by the number of those making proper claims to the stock, not by the number of those who might have made such claims but did not. *In re* Solomon & Co., 268 Fed. 108 (1920).

released. It is not a preference of the banks, because the banks are secured creditors anyway. It is not a preference in the obnoxious sense of the margin customers, because they are not creditors.[73] It is rather the performance of a fiduciary obligation resting upon the bankrupt irrespective of his financial condition up to the moment of bankruptcy. Of course the trustee, no more than the bankrupt, is bound to procure the release of pledged stocks to satisfy the demands of any customer who does not pay or tender the amount of his debt to the broker.

There is no good reason why this obligation should be suspended or extinguished by reason of bankruptcy. In *Richardson* v. *Shaw*[74] it was held that an insolvent broker may redeem pledged stocks for delivery to a margin customer up to the moment of bankruptcy. The discharge of this obligation by the trustee, who steps into his shoes, consists only in the payment of a debt of the bankrupt himself. It is not new business, but it is a legitimate part of the administration of the estate. It involves the exercise of no discretion. It is not the performance of the function of a broker like the purchase of stock to supply a deficiency.

This distinction is in accord with the general principle that a trustee in bankruptcy takes the property of the bankrupt subject to all valid claims, liens, and equities.[74] The bankrupt, as has been pointed out, is under two obligations: (1) one to maintain the necessary holdings of stock and (2) the other to procure the release from pledges of sufficient stock to meet the demands of customers. The first obligation relates to no stock that comes into the possession or control of the trustee. There is, therefore, no property to which any equitable obligation can attach, and it is of such a nature that the trustee cannot perform it. But the second obligation, on the contrary, exists with reference to the very stock which does come into the control of the trustee; and just as the bankrupt was bound to relieve that stock from the burden of pledges for the bankrupt's own debts, so the trustee's title to it is subject to the same obligation.

The obligation to substitute new for missing stock cannot survive, because there has been a breach of that obligation before the bank-

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[73] Richardson *v.* Shaw, 209 U. S. 365 (1908).

[74] COLLIER, BANKRUPTCY, 12 ed., 1117.

ruptcy. The trustee in bankruptcy cannot repair the delinquencies of the bankrupt, but must take the situation as he finds it. The case is no different from that of a trustee who is short in his trust funds.

But the obligation to redeem stock to meet demands of customers does not arise until demand has been made in any particular case. Until then the stocks are rightfully pledged, and the broker is guilty of no lapse. The trustee in bankruptcy, therefore, must perform that obligation, provided that such performance is within the scope of his functions in the administration of the bankrupt's estate.[75] He has no right to allow the pledged stocks to be taken to pay the debts of the bankrupt, because there is an outstanding obligation which the bankrupt has not broken that they shall not be so taken. It is this negative phase of the broker's obligation which survives, and attaches to the stocks which, although pledged, come under his control as a part of the bankrupt estate.

After all, the obligation to redeem pledged stock is merely incidental to the obligation to deliver stock on tender and demand by the customer, and has no independent existence by itself. If the obligation to deliver survives, the incident survives with it. The only way to prevent a breach of the broker's negative obligation not to permit the stock to be used for the payment of his own debts is for the trustee to redeem the stock that is demanded. Moreover, loans to the broker by the banks in excess of the broker's advances to customers represent sums not necessary to the margin business borrowed by the broker for his personal use in other matters. It is not just that the property of the broker's principals should be taken to pay such debts.[76]

It follows, therefore, that the trustee should pay from the general assets of the estate a sufficient sum to release the pledged stock for which proper demands have been made by customers.

It may be, however, that in any given case where a considerable number of the margin customers have elected to prove their claims as ordinary creditors, it will not be necessary to apply this doc-

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[75] "It would seem to follow that the customer would have a right to demand his stock of the trustee himself, as well as to receive it from the bankrupt, on paying whatever remained to be paid." Justice Holmes in Richardson *v.* Shaw, 209 U. S. 365, 385 (1908).

[76] Gorman *v.* Littlefield, 229 U. S. 19, 25 (1913).

trine. The excess, as has been defined, of loans made by the banks to the broker is primarily a charge or encumbrance upon all of the margin stock in the broker's possession or control, whether pledged or not; that is, it constitutes such a charge as between the members of the entire group of margin customers. As has been pointed out, they have all entered into the same relation under substantially the same contract with the broker as their common agent, and it is wholly a matter of accident what particular stock at any moment stands pledged by him under the authority given by all. But it follows from the principles that have been above set forth that if margin customers forego their rights in the stock their interest or equity therein passes to the benefit of those who remain. In such case the equity of those who elect to prove as creditors may be applied toward the release of a sufficient number of shares of stock of the various kinds to satisfy the demands of those who have properly pressed their claims to stock. If these unclaimed equities are not sufficient for the purpose, the remaining deficiency must be borne *pro rata* by all the margin customers who elect to claim their property rights, unless the trustee is bound to pay it from the general assets.

Another way of stating the same result is to say that the equitable interests of all the margin customers in the whole body of margin stocks constitute a fund applicable to the release of such stocks as are duly demanded. Any surplus belongs to the general assets of the bankrupt; any deficiency, if not paid by the trustee from the general assets, must be borne *pro rata* by the margin customers who demand their stocks. If the trustee is under no obligation to supply the deficiency, the same reason that denies the obligation to do so requires that the general fund provided by the margin stocks be diminished by the dividends payable to those margin customers who have elected to prove their claims as general creditors.

THE FIELD FOR LEGISLATION[77]

Suspensions or bankruptcies of brokers having a large business in margin stocks are generally scandalous because the brokers, before they admit insolvency, not only have disposed of stocks they should be carrying but have hypothecated stocks left in their hands

[77] This subject does not invade the field of "Blue Sky" laws, designed to prevent fraudulent sales of worthless securities.

to the limit of availability. Experience always has shown the danger of permitting men to invite business from the public which places in their hands large quantities of securities and money that they are free to use subject to no restraints save those of personal honor. The foregoing discussion makes it possible to predicate the main objectives to be aimed at for the protection of the public in the matter of margin stocks, although space forbids anything like an adequate treatment of the subject.

Plainly, legislation must have an eye to the broker's fiduciary relation to his margin customers collectively, not as individuals. Just as a banker receiving deposits should have approved resources equal to the sum of all the deposits, so a broker should have in his possession or control sufficient stocks to satisfy the demands of all his margin customers. The same collective view should be taken regarding the use of margin stocks as pledges for bank loans to the broker. Is the sum total borrowed excessive, that is, more than the broker legitimately requires for the purchase of margin stocks? It matters not at all for how much any particular stock is pledged. The broker's margin business is at least on an honest basis when the sum borrowed does not exceed the aggregate amount owed by margin customers; on the other hand, the broker as a fiduciary has not made an honest use of the power intrusted to him to make pledges of the stock if he borrows in excess of this amount.

Punitive legislation by itself is inadequate, for punishment comes too late, although its deterrent effect counts for something.[78] The evils to be corrected are at bottom due to the broker's methods of business.

The writer is strongly impressed by the need of some sort of supervision of the whole margin business to the end that brokers (1) shall keep in their possession or control sufficient stocks to meet the demands of all their customers; and (2) shall not abuse their fiduciary powers by use of margin stocks as pledges for loans not legitimately required for margin transactions. Incidentally such supervision faithfully administered would do more toward the abolition of "bucketing" than all the penal statutes hitherto invented.

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[78] See New York Penal Law, sec. 956.